

## Indiana; General Obligation

**Primary Credit Analyst:**

Steffanie Dyer, Chicago (1) 312-233-7007; steffanie\_dyer@standardandpoors.com

**Secondary Contact:**

John Kenward, Chicago (1) 312-233-7003; john\_kenward@standardandpoors.com

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# Indiana; General Obligation

## Credit Profile

Indiana ICR

*Long Term Rating*

AAA/Stable

Affirmed

## Rationale

Standard & Poor's Ratings Services has affirmed its 'AAA' issuer credit rating (ICR) on Indiana, reflecting our opinion of the state's:

- Diversifying economic base, but not insulated from the effects of the most recent recession, given its continued manufacturing concentration;
- Biennium budget that maintains a solid level of reserves going into the next budget cycle;
- Very active budget management with practices that have been consistently applied to maintain sound reserve levels, including the willingness of the administration to use its power to unallot appropriations and implement a lower cost structure; and
- Low overall debt levels.

Management continues to demonstrate a commitment to balanced operations. In April 2011, the state passed the fiscal 2012 and 2013 (June 30) biennium budget, which increases the general fund balance in both years, ending the biennium with a projected balance of more than \$1 billion. We are told that the budget for both fiscal years is structurally balanced. The budget was based on the April 2011 revenue forecast that shows an increase of 5.1% in revenues for fiscal 2012 compared with the new forecasted revenue for fiscal 2011 and a 3.7% increase in fiscal 2013 over fiscal 2012.

The state's biennium budget for fiscals 2010 and 2011 (June 30) dipped into reserves slightly, but maintained a solid \$1 billion at the end of the biennium. However, revenues did not perform as projected, with fiscal 2010 revenues missing the May 2009 projections that the budget was based on by \$879.1 million. Actual revenues for fiscal 2010 were down 5.6% compared to fiscal 2009. Through a combination of expenditure adjustments and a use of reserves, the state estimates that fiscal 2010 ended with a general fund balance of \$830.1 million, or 6.1% of operating revenue (on a budgetary cash basis), down from \$1.3 billion (combined operating funds) in fiscal 2009, or 10.2% of operating revenue. Funds included in combined operating funds--the Medicaid reserve, "rainy day" and state tuition reserve were all transferred to the general fund in fiscal 2010.

Through May 2011, revenues for fiscal 2011 are also tracking below the May 2009 forecast, by \$350.1 million so far. Even with lower revenues than anticipated, the state is currently projecting that fiscal 2011 will end with \$797 million, slightly down from fiscal 2010 (approximately \$33 million) and down from the \$1 billion originally projected in the biennium budget. However, fiscal year to date (May 2011), revenues are tracking slightly ahead of the new April 2011 forecast, up 1.1%, and have also improved on an annual comparison basis. Total general fund revenue through May 2011 is exceeding the previous year's revenues during the same period by \$976.7 million, or 9.1%. All but riverboat wagering revenues out of the major taxes are up year to date, with sales taxes increasing 4.9%, individual income tax up 17.3%, corporate income tax up 22.7%, and racino wagering tax gaining 7.4%.

Indiana's financial management practices are considered "good" under Standard & Poor's Financial Management Assessment (FMA). An FMA of good indicates that practices exist in most areas, although not all might be formalized or regularly monitored by governance officials.

Indiana's constitution does not allow new debt except to meet casual deficits in revenue, pay interest on state debt, or to provide funds for public defense, as such, the state has no general obligation (GO) or tax-supported revenue debt, but does have appropriation-backed debt. As of June 30, 2010, Indiana had about \$3.12 billion in appropriation-backed debt. The state's debt levels were low at \$482 on a per capita basis and 1.4% of personal income.

Based on the analytic factors we evaluate for states, on a scale of '1' (strongest) to '4' (weakest), we have assigned a composite score of '1.6' to Indiana. In our view, the 'AAA' ICR on Indiana reflects the state's proven commitment to and dramatic focus on strengthening the budget and structural balance through extensive use of management controls that has led to maintenance of solid reserve levels despite underperforming revenues during the recession.

## Outlook

The stable outlook reflects the state's strong financial position and management's commitment to returning Indiana's budget to structural balance. In addition, despite any negative variance from projected revenues, we expect the state to make adjustments as necessary to restore budgetary balance. We believe the state has made a strong commitment to strengthen budget and management controls and overall financial management. The current stable outlook is based on our expectation that these practices will continue.

## Government Framework

Neither Indiana's constitution nor statutes require the state to initially approve or maintain a balanced budget throughout the year. However, there are mechanisms in place that provide the state with the flexibility to adjust both revenues and expenditures if deemed necessary. For example, only a simple majority of the legislature is required to raise taxes, and there is no constitutional constraint on the amount of the increase. In addition, state statute provides that the state budget director, with the approval of the governor, can withhold allotments of appropriations to agencies if revenues are less than anticipated in order to prevent a deficit. The state provides a limited level of assistance to local governments, but does fully fund local school general operations as a result of the property tax reform passed in 2008. In fiscal 2010, the administration did use its allotment power and withheld funds from schools. The state is not a voter-initiative state, providing further flexibility.

Indiana's constitution does not allow new debt except to meet casual deficits in revenue, pay interest on state debt, or to provide funds for public defense. As a result, the state has no GO or tax-supported revenue debt, but does have appropriation-backed debt. There is no limit on the amount of appropriation debt that can be issued, but the debt must first be authorized by the legislature. Given that the state's debt is appropriation-backed debt, there is no legal priority for debt payments.

We have assigned a score of '1.2' out of '4.0' to Indiana's government framework, where '1.0' is the strongest score and '4.0' the weakest.

## Financial Management Assessment: 'Good'

Standard & Poor's deems Indiana's financial management practices "good" under its FMA. An FMA of good indicates that practices exist in most areas, although not all might be formalized or regularly monitored by governance officials.

Among Indiana's management techniques are:

- In terms of revenue assumptions and forecasts, the state convenes every December with a budget committee consisting of members from the house and senate along with economists to prepare the upcoming revenue forecast. The same group updates the revenue forecast in April of odd-numbered years and compares the budget to the April forecast.
- In terms of expenditures, the legislature sets the appropriations for the biennium. However, the budget director has the power to forgo allotting appropriations and, therefore, may control expenditures if revenues come in under the forecast.
- The state has a biennium budget process. Indiana's practice is not to amend the budget. If there is a recession, the budget director has the power to forgo allotting appropriations.
- The state has a four-year revenue and expenditure forecast performed internally, but does not have a formal long-term revenue forecast provided to the legislature.
- In terms of long-term capital planning, the state universities do 10-year plans, as does the Indiana Finance Authority for lease transactions, but, like most states, Indiana does not yet have a formal capital improvement plan. However, the state is in the process of formulating a formal capital improvement plan that will align state capital goals with funding sources.
- The state has its own investment policy.
- The state's debt management policies are comprehensive and include a well-defined swap management policy.
- In terms of liquidity and reserves, the state has an informal goal of maintaining between 10% and 12% of annual operating revenues in the general fund.

## Budget Management Framework

Once the budget is approved, the state monitors both revenue and expenditure performance on a monthly basis. With the approval of the governor, to prevent a deficit, the state budget director can withhold allotments of appropriations to agencies if revenues are less than anticipated. Budget adjustments have historically been implemented regularly and on a timely basis.

We have assigned a score of '1.5' to the state's financial management, where '1.0' is the strongest score and '4.0' the weakest.

## Economy: Diversifying But Still Vulnerable

Indiana's economy is more concentrated in the manufacturing sector than the U.S., but currently depends less on manufacturing than it has in the past. Nevertheless, this sector remains an important component in the state's economy and factors into the state's increased unemployment levels in 2009 and 2010. In 2008, manufacturing made up 18% of the state's employment base compared to 10% for the U.S. Automotive manufacturing continues

to have a significant presence, and its diversification beyond the American automakers to include foreign-owned companies adds a degree of stability to the state's economy. The state's manufacturing sector is not all auto-related; pharmaceuticals and durable household goods are also prominent products. Eli Lilly & Co., a pharmaceutical company headquartered in Indianapolis, continues to be an important presence in Indiana, with 12,068 jobs. Although Eli Lilly did lay off staff during the recession. Other major employment sectors in the state include: trade/transportation/utilities (20% of the state's jobs), government (15%), education and health (14%), leisure and hospitality (10%), and professional and business services (10%). Major private, for-profit employers in the state include:

- Wal-Mart Stores Inc. (39,452 employees),
- Eli Lilly (12,068),
- The Finish Line Inc. (11,100),
- Kroger Co. (9,800), and
- FedEx Corp. (7,600).

In addition to the significant federal, state, and university presence, nonprofit health care providers are also some of the state's leading employers.

The state's 2009 unemployment rate jumped to 10.4% from 5.9% in 2008, decreasing slightly to 10.2% in 2010. The U.S. unemployment rate was 9.3% and 9.6% in 2009 and 2010, respectively. Unemployment is on the decline in the state, with a rate of 8.8% (not seasonally adjusted) in March 2011. According to IHS Global Insight, the state's employment should return to prerecession levels no earlier than 2014, slightly behind the national economy's projected recovery.

Job creation efforts are still underway through the Indiana Economic Development Corp.'s (IEDC) actions to attract local, domestic, and international companies. Since the agency's inception in 2005, it has collaborated with more than 1,000 businesses that committed to creating more than 126,000 new jobs with investment surpassing \$25 billion. In addition, the state recently lowered the corporate income tax rate to 6.5% from 8.5% in an effort to become more attractive to businesses.

Between 2000 and 2010, Indiana's population grew 6.6% to 6.48 million, but not as quickly as the U.S. population, which increased 9.7% during the same time period. Indiana's per capita personal income is 86% of the U.S. level while the state's gross state product per capita is 88%. Real gross domestic product growth lagged the nation in 2009, falling 3.6% compared with a decrease of 2.1% for the U.S.

We have assigned a score of '2.4' to the economy, where '1.0' is the strongest score and '4.0' is the weakest.

## **Budgetary Performance**

The state bases its biennium budgets on revenue projections created by the Revenue Forecast Technical Committee with economic variables provided by IHS Global Insight. The revenue forecasts are performed once in December of even-numbered or nonbudget making years and twice in odd-numbered years in April and December.

The current administration has focused on the expenditure side during the most recent recession and did not raise taxes to compensate for lower revenues. Even though revenues came in \$879.1 million less than the budgeted projections, the state ended fiscal 2010, on a budgetary cash basis, with a general fund balance of \$830.1 million, or

6.1% of operating revenue, down \$504 million from the projected fiscal 2010 balance. Fiscal 2009 combined reserves (also include rainy day, Medicaid, and state tuition reserve funds) were \$1.3 billion, or 10.2% of operating revenue. The rainy day, Medicaid, and state tuition reserve funds had zero balances at year-end fiscal 2010; all balances were transferred to the general fund. The state currently projects fiscal 2011 to end with \$797 million, down approximately \$33 million from fiscal 2010, with revenues through May 2011 compared with 2009 budgeted projections lower by \$350.1 million.

Based on the state's comprehensive annual financial report (CAFR), the state ended fiscal 2010 with a \$785.2 million operating surplus after transfers on a generally accepted accounting principles (GAAP) basis. The ending general fund balance was \$2.3 billion, or a very strong 22.2% of operating expenditures. The unreserved fund balance was \$1.8 billion, or a very strong 16.9% of operations. In fiscal 2010, sales tax and income tax revenues were the largest sources of revenues at 51% and 38%, respectively.

In April 2011, the state passed the fiscal 2012 and 2013 biennium budget, which increases the general fund balance in both years, ending the biennium with a projected balance of more than \$1 billion. We are told that the budget for both fiscal years is structurally balanced.

Indiana has maintained sufficient liquidity to avoid cash flow borrowing. The state does not have a history of issuing short-term debt for cash flow purposes. If needed, the state has the flexibility to borrow from other dedicated funds. The state monitors its cash flow on a regular basis.

We have assigned a score of '1.3' to the state's budgetary performance, where '1.0' is the strongest and '4.0' is the weakest.

## Debt And Liability Profile

Indiana's constitution does not allow new debt except to meet casual deficits in revenues, to pay interest on state debt, or to provide funds for public defense. As a result, the state has no GO or tax-supported revenue debt, but does have appropriation-backed debt. As of June 30, 2010, Indiana had about \$3.12 billion in appropriation-backed debt. This figure includes \$987.2 million in stadium and convention center bonds that are actually supported by revenues from local food and beverage, hotel, rental car, and facility admission taxes. The portion of the state's total debt that has been consolidated under the Indiana Finance Authority consists of \$25.5 million for recreation development commission bonds, \$150.0 million for airport facilities bonds, \$6.3 million for aviation technology center bonds, \$1.2 billion for highway revenue bonds, and \$739.7 million for state office building commission bonds as of June 30, 2010. The state has never had to provide support to debt backed by its moral obligation pledge and, although the state has appropriated for the university fee replacement debt in the past, there is no appropriation pledge supporting this debt and the state is not obligated to appropriate for it in the future. Therefore, we currently do not include \$549.2 million in bond bank debt that is secured by the state's moral obligation pledge and \$1.35 billion in university fee replacement debt in Indiana's debt calculation.

As of June 20, 2010, the state's debt levels were low at \$482 on a per capita basis and 1.4% of personal income. Appropriation-backed debt service accounted for an estimated 2.5% of the state's general fund expenditures in fiscal 2010, which we consider moderate. Amortization is average, with approximately 40% retired over 10 years.

The Indiana State Teacher's Retirement Fund (TRF) consists of the closed pre-1996 account and the new 1996

account. The funded ratio for the entire TRF has held steady and was 44.3% (funded ratios for most state plans are usually in excess of 80%) at June 30, 2010, up from 41.9% at fiscal year-end 2009, but down from 48.2% at fiscal year-end 2008; the state plans to continue funding the closed plan on a pay-as-you-go basis. In 1996, Indiana closed the plan and new hires were moved to actuarially sound plans. The new plan, which is the responsibility of school districts, includes transferred teachers from the state plan. As of June 30, 2010, the funded ratio was 33.1% for the closed plan and 94.7% for the new plan. As part of Indiana's plan to address the significant unfunded liability, the state also adopted a 30-year amortization schedule and established a pension stabilization fund, which should limit the annual growth rate of general appropriations for the TRF to less than historical general revenue growth rates. The pension stabilization fund is a dedicated fund in the TRF, designed to accumulate a balance during a 12-year period. The pension stabilization fund is allowed to smooth out yearly general fund contribution growth to less than 3%; the original statute allowed use of the fund to start in 2007. We are told that the pension stabilization fund has a current value of approximately \$1.93 billion and continues to receive \$30 million annually from the Hoosier Lottery.

The state's Public Employee Retirement Fund is the state's largest plan with a funded ratio of 85.2% on \$14.5 billion of actuarial accrued liabilities at fiscal year-end 2010. This includes active, retired, and disabled employees at both the state and local levels. The state also has five other smaller pension plans.

The state's combined funded ratio for its pension plans was below average at 64.5% as of fiscal year-end 2010. Total unfunded state pension liabilities of \$13.7 billion (80% represents the closed TRF plan) translate to a below-average \$2,110 per capita and 6.3% of personal income. The state makes its annual required contribution for its pension systems in most years.

In terms of other postemployment benefits (OPEB), the unfunded actuarial accrued liability as of valuation date June 30, 2009, was \$524.9 million, or a low \$81 per capita, with an annual required contribution of \$54.3 million. The state is currently funding the OPEB liability on a pay-as-you-go basis. Retired state employees can join Indiana's health plans, but they must pay the entire cost. However, there are three plans under which the state does pay part or the entire amount of the premiums for retirees: legislators, state police, and conservation officers. However, in July 2007, legislators began to be covered by a defined contribution plan.

We have assigned a score of '1.8' to the state's debt and liability profile, where '1.0' is the strongest score and '4.0' the weakest.

## **Debt Derivative Profile, '1': Minimal Risk**

Standard & Poor's assigned the Indiana Finance Authority a Debt Derivative Profile overall score of '1' on a scale of '1' to '4', with '1' representing the lowest risk and '4' the highest.

The overall score of '1' reflects Standard & Poor's view that the authority's swap portfolio reflects minimal risk at this time due to the following factors:

- The requirement of a highly rated swap counterparty and collateral posting requirements at certain rating thresholds;
- A low degree of involuntary termination risk under the authority's swaps, due to a wide ratings trigger spread between the rating on the authority and the potential collateral posting threshold;

- The above-average economic viability of the swap portfolio during stressful economic cycles; and
- Strong management practices and policies.

The authority financed \$786.525 million of variable-rate bonds from 2005 to 2008 to provide funds for the stadium and convention center projects. As of June 30, 2010, only \$747.9 million of the bonds have related swap agreements. The authority entered into forward-starting synthetic fixed-payer swaps to match the future debt service on the bonds after the construction period is complete (three years forward for the stadium and five years forward for the convention center bonds) through the final maturity of each proposed series. Under the terms of the forward-starting swap, the authority will pay a fixed rate and receive the Securities Industry and Financial Markets Association municipal swap index. The state entered into a notional amount of \$611.525 million in forward-starting swaps on the stadium bonds with Bear Stearns (novated to JPMorgan Chase Bank); JPMorgan Chase Bank; and Goldman Sachs Group (guarantor for Goldman Sachs Bank USA). Concurrently with the 2008A stadium bonds, Indiana entered into a fixed payer swap with The Bank of New York Mellon, with similar terms as the previous swaps and a notional amount of \$46.875 million. The state also entered into a notional amount of \$265.175 million in forward-starting swaps on the convention center bonds with Bear Stearns (novated to JPMorgan Chase Bank), JPMorgan Chase Bank, Goldman Sachs Group (guarantor for Goldman Sachs Bank USA), and Merrill Lynch Capital Services Inc. With the state's issuance of its 2009A convention center bonds, the state used bond proceeds to terminate the JPMorgan Chase (including Bear Stearns) and Merrill Lynch swaps for the convention center project, leaving Goldman Sachs Group as the sole swap counterparty outstanding with a notional amount of \$98.115 million. In the state's swap policy, the counterparty must be rated at least 'AA-' or is required to post collateral at certain rating levels to mitigate concerns over counterparty risk. The state manages its swap program with an adopted swap policy that thoroughly addresses the risks associated with derivatives. Due to the low degree of termination risk, Standard & Poor's is not factoring in the swaps' value at risk as contingent liabilities for the state.

## Related Criteria And Research

USPF Criteria: State Ratings Methodology, Jan. 3, 2011



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